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At your request, we have reviewed a notice of proposed adjustment (designated as number 19) and the related explanation of items, which we understand were previously given to the taxpayer in this case. You have previously received written advice on these issues. After review of the previous memorandum by the National Office, we are reissuing the memorandum with

- described as "credit/rebill units," be excluded from the (2) Should certain taxpayer's ending inventory?
- (3) Has the taxpayer properly identified certain items within the pool as Class A, Class B, and Class C items, as those terms are defined in a closing agreement which governs certain aspects of the taxpayer's LIFO inventory accounting for the taxable years at issue?

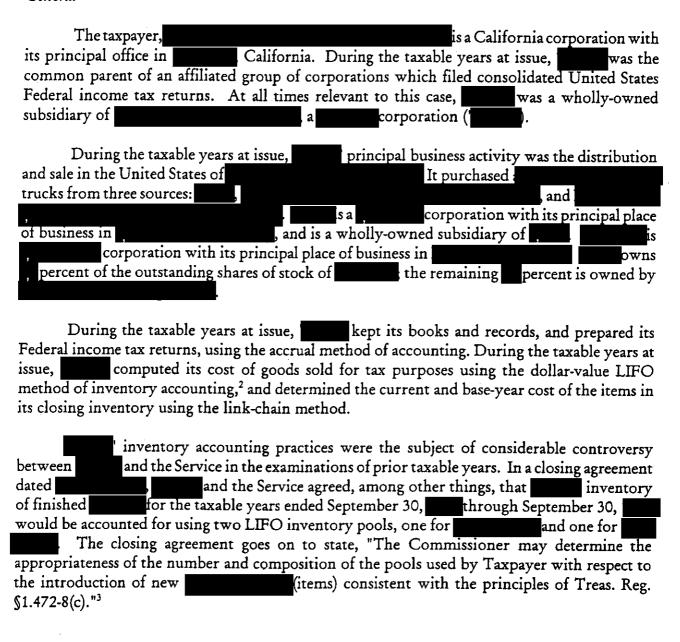
For the reasons set forth below, with respect to issue 1 it is our opinion that the taxpayer n its existing LIFO inventory pool of is permitted to include We are unable to render definitive opinions with respect to issues 2 and 3 at this time, because the facts necessary to allow us to do so have not been made available to us. However, in order to assist you in reviewing your records and assembling the necessary facts, we have included a discussion of the applicable legal principles and recommended specific information which should be obtained.

FACTS

We understand the relevant facts to be as follows.1

¹ Our understanding of the facts of this case is limited to the facts set forth in your explanation of items. We have not undertaken any independent investigation of the facts of this case. If the actual facts were to be different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

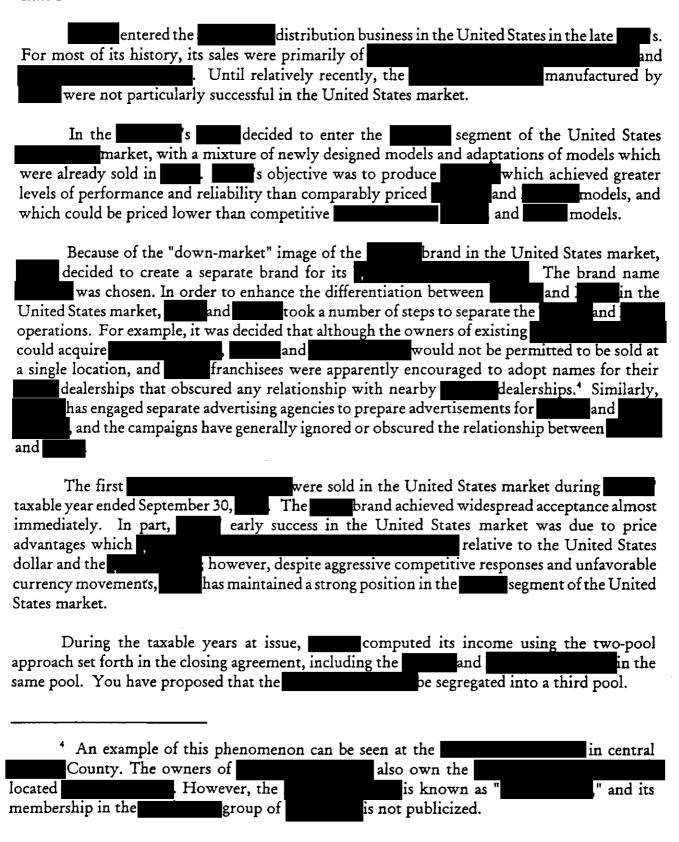
General



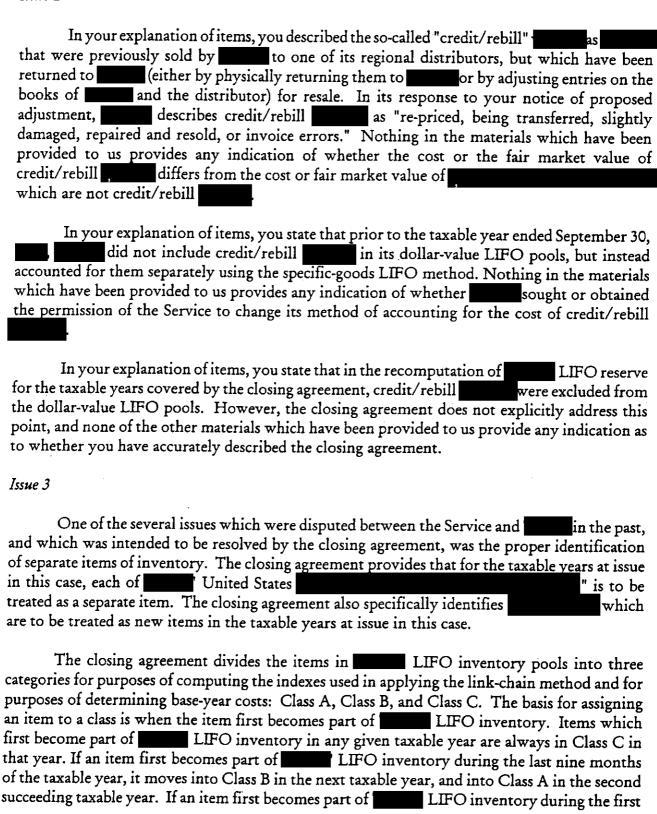
² adopted the dollar-value LIFO method beginning in its taxable year ended September 30,

³ A copy of the closing agreement is attached to this memorandum and marked as Exhibit A.

Issue 1



Issue 2



three months of the taxable year, it never moves into Class B; instead, it moves directly into Class A in the next taxable year.

In your explanation of items, you state that:

- (1) certain items which were classified as Class C in the taxable year ended September 30, were erroneously left in Class C for the taxable year ended September 30,
- other items which were classified as Class C in the taxable year ended September 30, were erroneously moved to Class A for the taxable year ended September 30, when they should have moved to Class B;
- (3) certain items which were classified as Class A in the taxable year ended September 30, were erroneously placed in Class B for the taxable year ended September 30,
- one item which was classified as Class C in the taxable year ended September 30, was erroneously left in Class C for the taxable year ended September 30, and
- one item which was classified in Class C in the taxable year ended September 30, was erroneously moved to Class A for the taxable year ended September 30, when it should have been moved to Class B.

None of the materials which were have been provided to us provide any information regarding the exact dates on which any of the disputed items first entered inventory.

LEGAL ANALYSIS

General

I.R.C. Section 471(a) provides in general that if the use of inventories is necessary to clearly determine a taxpayer's income, "inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." I.R.C. Section 472(a) permits a taxpayer which is required to keep inventories to elect to use LIFO, "... in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income." The term "best accounting practice in the industry" is generally interpreted as being synonymous with generally accepted accounting principles. Wal-Mart Stores,

Inc. v. Commissioner, 153 F.3d 650, 656 (8th Cir. 1998) (citing Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979)). A method of inventory accounting will be found to clearly reflect income if it complies with GAAP, is consistently used, and produces accurate results. Wal-Mart, 153 F.3d at 657 (citing Treas. Reg. § 1.446-1(a)(2)).

Initially, the Service contested taxpayers' attempts to use dollar-value LIFO, taking the position that only specific-goods LIFO was permitted under the Code. However, after a series of adverse decisions by the Tax Court, see, e.g., Hutzler Brothers Co. v. Commissioner, 8 T.C. 14 (1947), the Service promulgated regulations governing the use of dollar-value LIFO. See Treas. Reg. § 1.472-8.

Issue 1

The proper identification of "items" of inventory, and the proper accumulation of items into LIFO "pools," are crucial to the proper use of dollar-value LIFO. Regulations Section 1.472-8(c) provides that

Items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the business is engaged is an important consideration.

In determining whether separate LIFO inventory pools should be maintained, the courts have generally looked to whether the taxpayer is engaged in more than one trade or business, and required a separate inventory pool for each business. See, e.g., UFE, Inc. v. Commissioner, 92 T.C. 1314, 1321-22 (1989); Amity Leather Products, Inc. v. Commissioner, 82 T.C. 726 (1984).

Although the matter is not free from doubt, in our view the distribution of is a single trade or business, so that the use of a single LIFO inventory pool for and is permissible.

In a number of cases and rulings involving retail automobile dealers, the courts and the Service have permitted the two-pool approach used by the taxpayer. Richardson Investments, Inc. v. Commissioner, 76 T.C. 736 (1981); Fox Chevrolet, Inc. v. Commissioner, 76 T.C. 708 (1981); Rev. Proc. 97-36, 1997-33 I.R.B. 14. In Rev. Proc. 97-36, the Service expressly stated that under the alternative dollar-value LIFO method for dealers described therein, all automobiles, regardless of manufacturer, should be placed in a single pool. If that treatment is appropriate, then a fortiori it would seem appropriate to place two different model lines manufactured by the same manufacturer in a single pool. Thus, it appears that the taxpayer's two-pool approach is customary in the automobile industry—a consideration which is of great importance under the

Regulations.⁵ We are unable to perceive any principled reason why a wholesale distributor should be treated differently than a retail dealer

We acknowledge that if the nature of the business changes over time, a different
conclusion might be appropriate for subsequent taxable years. In particular, we note that all of
the current models are manufactured by the in while an increasing percentage of
the models sold by an in the United States are manufactured by
in the United States. If this trend continues, it may be appropriate at some future time to require
separate pooling of and and See Amity Leather, supra (taxpayer required
to maintain separate pools for goods it manufactured in the United States and goods it purchased
from a wholly-owned subsidiary in Puerto Rico). However, for the taxable years at issue, a single
pool for parameters is not inappropriate6
pool for ,

Issue 2

Regulations Section 1.472-8(g)(1) provides in relevant part as follows:

In view of the history and the underlying policy of the pooling concept in the dollar-value method, it would appear that the key factor in determining the scope of a particular pool should be "substitutability of goods." Conceptually, a taxpayer should pool goods together on the basis of consumer preferences and the acceptability of substitute products.

We acknowledge that an argument for		could be made based	
on Mr. Schneider's "substitutability" theory. It could be argued with some force that a \$			
is not an accepta	ble substitute for a \$1	and vice	
versa). However, on balance we do no	ot find this argument co	ompelling. There has always been,	
and continues to be, significant over	lap between the	and product lines. For	
example, the current		sely resembles the	
, and the	and	are virtually	
identical except for		In addition, recent press reports	
indicate that the soon to be introduce	ed	will be priced substantially	
below the price of fully equipped	and	·	

As you know, two other similarly situated distributors,
have adopted the same two-pool approach as the taxpayer. In a 1996 field service advice memorandum issued to this office in connection with an examination of another taxpayer, the office of the Assistant Chief Counsel (Domestic Field Service) found the two-pool approach to be permissible.

⁶ But see 1 L. Schneider, Federal Income Taxation of Inventories, §13.01[2], at p. 13-8:

(1) Change in method of pooling. Any method of pooling authorized by this section and used by the taxpayer in computing his LIFO inventories under the dollar-value method shall be treated as a method of accounting. Any method of pooling which is authorized by this section shall be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446-1.

Thus, assuming that elected to separately account for credit/rebill using the specific-goods LIFO method at the time it elected to use dollar-value LIFO as its standard method of inventory accounting, it must continue that treatment unless it obtains the permission of the Service to change by filing a Form 3115.⁷

Issue 3

Regulations Section 1.472-8(e)(1) provides that ordinarily, taxpayers using dollar-value LIFO must use the double-extension method to determine the base year cost and current year cost of a dollar-value LIFO pool. However, where a taxpayer can show that use of the double-extension method is impractical because of the number of items in a pool or rapid changes in the items in a pool, the use of an index or link-chain method is permitted. The use of a link-chain method is customary in the automobile distribution industry. See, e.g., Rev. Proc. 92-79, 1992-2 C.B. 457 (requiring dealers electing the alternative LIFO method to use the link-chain method).

The regulations do not prescribe any particular link-chain method which must be used. The link-chain method is generally similar to the double-extension method, except that instead of using the year in which the taxpayer adopted LIFO as the base year for purposes of computing base-year cost, each year's current costs are restated in terms of the immediately preceding year's costs, and those costs are indexed back to the base year using a cumulative index. See 1 Schneider, § 14.02[3], at 14-99.

In this connection, we note that if credit/rebill are meaningfully different from the rest of inventory, or are not held for sale to customers in the ordinary course of business, there is support in the case law for not allowing them to be included in dollar-value LIFO pools. In B.A. Ballou & Co. v. United States, 7 Cl.Ct. 658, 85-1 U.S. Tax Cas. [CCH] ¶9290 (Cl.Ct. 1985), the taxpayer was a jewelry manufacturer which accounted for the gold it purchased for use in manufacturing using dollar-value LIFO. During the taxable years at issue, the taxpayer also engaged in speculative purchases and sales of gold. The court held that the gold purchased for speculation could not be included in the taxpayer's dollar-value LIFO pool, because it had not been purchased for sale in the ordinary course of business or for incorporation into a product to be sold in the ordinary course of business.

As described above, the closing agreement groups all of the items in LIFO inventory pools into three classes for purposes of computing indexes and base year costs, rather than computing indexes and base year costs separately for each item. Treas. Reg. § 1.472-8(e)(2) provides that the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year. Clearly, so method fails to meet the requirements of the regulations. Unfortunately, both and the Service are bound to follow the closing agreement for the years to which it applies. See, e.g., Estate of Johnson v. Commissioner, 88 T.C. 225, 231 (1987), aff d. unpub. op., 838 F.2d 1202 (2d Cir. 1987) ("A closing agreement, once approved by the Secretary, is a final and conclusive agreement between the parties as to all matters contained therein."). We strongly recommend, however, that this particular closing agreement not be used as a model for future closing agreements.

With respect to category (1) described above, we agree that items which were classified as Class C in the taxable year ended September 30, and cannot properly be included in Class C for the taxable year ended September 30, because they should be moved to Class B or to Class A for the taxable year ended September 30, because they should be moved to Class B or to Class A for the taxable year ended September 30, because they should be moved to Class B or to Class A for the taxable year ended September 30, because they should be moved to Class B or to Class A for the taxable year ended September 30, because they should be moved to Class B or to Class A for the taxable year ended September 30, because they are they should be moved to Class B or to Class A for the taxable year ended September 30, because they are the

Similarly, with respect to category (2) described above, in the absence of any information as to when those items first appeared in LIFO inventory, we cannot determine whether those items should have been included in Class B or in Class A for the taxable year ended September 30,

With respect to category (3) described above, we agree that those items should have been included in Class A for the taxable year ended September 30, . Under the structure set forth in the closing agreement, Class A is the residual class, and once an item enters Class A, it remains there until it is no longer part of the LIFO inventory pool.

With respect to category (4) described above, we agree that that item cannot properly be included in Class C for the taxable year ended September 30, Indeed, if that item was properly included in Class C for the taxable year ended September 30, then the only class in which it could properly be included in the taxable year ended September 30, is Class A.

Finally, with respect to category (5) described above, in the absence of any information as to when that item first appeared in LIFO inventory, we cannot determine whether it should have been included in Class B or in Class A for the taxable year ended September 30,

CONCLUSIONS AND RECOMMENDATIONS

For the reasons set forth above, it is our opinion that (1) is permitted to include and and in the same dollar-value LIFO inventory pool; (2) credit/rebill

should be excluded from dollar-value LIFO pools unless dollar-value before obtained the Service's consent to include them; and (3) at least some of your proposed reclassifications of items are appropriate under the terms of the closing agreement.

We recommend that you review the Service's files, and conduct whatever other information-gathering activities you deem appropriate under the circumstances, in order to definitively determine (1) whether ever obtained the Service's permission to change its method of accounting to include credit/rebill in its dollar-value LIFO pools and (2) the exact dates on which the items in question in issue 3, above, first entered dollar-value LIFO inventory. Once that information has been obtained, we recommend that you revise your computations of the amount of the adjustment in accordance with your findings and the legal opinions set forth in this memorandum.

If you have any questions regarding any of the matters discussed in this memorandum, please feel free to call the second of this office at the second of this office at the second of the matters discussed in this memorandum,